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C O N F I D E N T I A L SANTIAGO 002525

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TAGS: ECON EFIN ETRD PREL CI
SUBJECT: IS CHILE AN ECONOMIC TIGER OR JUST A BIG HOUSE CAT?

REF: A. SANTIAGO 2411
¶B. SANTIAGO 2523

Classified By: CDA Emi Lynn Yamauchi. Reasons: 1.4 (b and d).

¶1. (C) Summary: Chile continues to attract foreign direct investment, but largely to a few traditional sectors such as mining and electricity. Potential value-added sectors which will be key to Chile's attaining the next stage of development attract almost no foreign investment. Thus far, Chile has been unwilling to offer special tax advantages to foreign companies, so as to "not discriminate" against local companies. For most Chileans, the lack of direct foreign investment is not a "crisis," with the Bachelet administration's general economic policy being "don't fix it if it ain't broken." Fortunately for Chile, some private sector business leaders are beginning to caution against Chile resting on its laurels and have urged the government to do more to attract investment. While Chile considers itself in the same league as other economic tigers (Ireland, Singapore, etc.), the economic indicators tell another story. There are signs that Chile is plateauing and projections for real GDP growth in 2006 continue to be lowered. If Chile wishes to be more than just a big tabby, it must do more than tinker with reform. End summary.

Foreign Investment Goes to the Basics

¶2. (U) As of August, new inflows of foreign direct investments (FDI) reached just over USD 3.4 billion, up 52 percent after a dismal 2005. However, nearly 80 percent of FDI is directed at four sectors: electricity, gas, water and mining. Additionally, much of the jump this year has been created through mergers and acquisitions, not by projects leading to economic growth or significant job creation. Osvaldo Rosales, who was the main GOC negotiator for the U.S.-Chile Free Trade Agreement, told Senior Econoff that "without more aggressive policies to attract FDI, it is no surprise that FDI is not higher."

¶3. (SBU) As the Bachelet administration seeks to foster innovation (reftel A), there's very little money following the rhetoric. While there is nothing wrong with capital being directed to core sectors, the FDI inflow is not helping develop knowledge-based industries, which the GOC says it needs. Additionally, domestic spending is not going to innovation either, with only 0.6 percent of GDP spent on

research and development.

GOC: Tone Deaf?

¶4. (C) In recent public comments and private discussions with GOC officials, Post has highlighted the link between attracting foreign investment and development. We have suggested Chile look to the Asian and European "tigers" -- particularly smaller countries like Ireland, Singapore and New Zealand -- as examples of countries that prospered by attracting foreign investment. It is unclear whether GOC officials understand the connection between FDI and development, or whether Chile is willing to take the steps necessary to attract the investment. Foreign Ministry Director General for External Relations Carlos Portales has expressed doubt that the center-left Concertacion government, given its political orientation and its criticism of Pinochet's neoliberal economic policies, would ever offer incentives to attract foreign investment. Such action could be interpreted as "discriminatory" against Chilean companies. Like many other government officials, Portales suggested Chile was performing relatively well and did not seem overly concerned.

¶5. (U) Somewhat surprisingly, Portales suggested that the American Chamber of Commerce (AMCHAM), in conjunction with other chambers and relevant GOC agencies, convene a seminar to discuss the Tigers' successes and lessons that could be applied to Chile. Post will discuss Portales' proposal with AMCHAM.

If At First You Don't Succeed, Give Up

¶6. (C) As part of an effort to market Chile as a small sometimes overlooked market, the GOC has tried to bundle projects to improve FDI inflows. In September, President Bachelet led a GOC roadshow to New York, hoping to obtain investment funding for a series of energy projects. During Colombian President Uribe's visit to Chile at the end of November, the GOC hosted a seminar to promote "Chile as a platform" in Latin America for doing business in Asia. Minister of Energy and Mining Karen Poniachik -- one of the architects of the September energy roadshow in the U.S. -- lamented to the Ambassador that the roadshow was a disappointment and had not led to new investment. The GOC was unlikely to try bundling again; a second leg of the roadshow to be held in London was canceled.

Serious Reforms or Just Tinkering?

¶7. (SBU) On November 28, Finance Minister Andres Velasco unveiled reforms to promote investment and business growth, hoping to halt the Chilean economy's deceleration. With projected real GDP growth in 2006 constantly being reduced (at a time of continued near record copper prices), and now down to 4.5 percent after 6.3 percent growth in 2005 and 6.1 percent growth in 2004, interest in the GOC's stance has been high. Proposed reforms are in "government modernization," human capital, capital markets and labor reform. Initial response was positive, but further analysis has led many to conclude that it's really more tinkering than substantive reform. The American Chamber of Commerce said the program was at least a move in the right direction, while adding that more was needed. Chile's ability to attract FDI to innovative sectors will depend in part on whether it defines -- and makes known -- a policy on intellectual property rights. And then enforces it.

The Chilean Tiger?

¶8. (SBU) Some Chilean officials (including Foreign Minister Foxley) like to think of Chile as playing in the same league as Ireland, Singapore and the Baltic states. However, when the GOC is unsure of itself or when it does not want to step

out in front and lead, these same officials fall back on puffing up Chile in drawing favorable comparisons between Chile and its less economically-successful neighbors. Former lead FTA negotiator Rosales also told Senior Econoff that while Chile's network of trade agreements has given trade a big boost, they are just a first step and the real challenges lie ahead in trying to find ways for Chile to profit from them long term.

¶9. (C) On that count, there is a growing perception that Chile is at least running the risk of stagnating economically. Rankings from the World Bank, IMF and international think tanks show Chile scoring poorly in labor flexibility, Intellectual Property Rights (IPR) protection, and government bureaucracy. While its economic achievement and success in reducing poverty over the last 15 years are impressive, Chile is no longer competing with its past. It is competing with more dynamic economies in Asia and Europe, which have clear policies on IPR, are ready to offer incentives to foreign investors and provide labor flexibility -- something politically impossible for Chile. Chile seeks greater FDI inflows, but is unwilling to offer special tax advantages to foreigners. The concept of venture capital is not well developed in Chile, but in conversations with the Ambassador, GOC interlocutors have made it clear Chile will stick to its quaint notion of "equity" and not favor outside investors over domestic ones.

Comment

¶10. (C) While the GOC is not eager to see growth slowing and foreign investment flowing just to core sectors, the newly-unveiled reforms give no sense of urgency to making Chile more competitive. As we have seen with other issues (e.g. UNSC election), convincing Chileans of the need to think beyond the region is no small undertaking. The Bachelet administration shows no signs of altering Chile's successful economic policies. It appears content with continuing past governments' policies of expanding the network of free trade agreements as the most effective vehicles to increase Chilean exports. Efforts to attract FDI, especially to new sectors, will have to wait.

¶11. (C) We see no indication of a vision for the future: no clear policies on how Chile rises to the next level economically, and how it joins the ranks of countries like Ireland, Singapore and New Zealand. Maybe even worse, it would seem Chileans do not even realize they are competing with these countries and other potential future stars like Vietnam for capital, resources, and attention. Chileans who travel to Asia marvel at the energy, dynamism and anything goes mentality of a country like Vietnam. However, on a policy level Chile tends to dismiss such a country as a potential competitor, preferring to see it as a second-rate, communist country. Without denigrating the value of promoting social policy goals (education and health care), we are not optimistic the Bachelet administration will do the necessary to ensure that Chile makes it to the next level.
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